No. 12147

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

FRANCIS F. QUITTNER, as Trustee in Bankruptcy of the Estate of Alvera Gordon Jones, doing business as Le-Roy Gordon Beauty Salons,

Appellee,

vs.

SECURITY-FIRST NATIONAL BANK OF LOS ANGELES, a National Banking Association,

Appellant.

Appeal from the United States District Court for the Southern District of California Central Division

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APPELLANT'S OPENING BRIEF.

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Statement of Pleadings and Evidence.

This is an appeal by Defendant from a judgment in favor of Plaintiff in the sum of $1,650.00 with interest thereon at the rate of 7% per annum from July 16, 1948.

The pertinent allegations of the Complaint [R. 2-4] are:

That within four months before the filing of the petition in bankruptcy the bankrupt paid and transferred to the Defendant sums totaling $1,650.00; that these payments were made on account of an antecedent debt owed by the bankrupt and were made while the bankrupt was insolvent, thus enabling the Defendant to obtain a greater percentage of its debt than other creditors of its class;

and that, at the time of the payments the Defendant had reasonable cause to believe that the bankrupt was insolvent, and that said transfers would effect a preference.

The Answer of the Defendant [R. 4-7] denies that it ever obtained any preferential interest by reason of any matters or things set forth in the Complaint; denies, for lack of knowledge, information, or belief, that the payments were made or suffered by the bankrupt while the bankrupt was insolvent; denies, for lack of knowledge, information, or belief, that the effect of the payments was to enable it to obtain a greater percentage of its debt than other creditors of the same class; and denies positively that at the time of the transfers or payments it had reasonable cause to believe that the bankrupt was insolvent, and that the transfers would effect a preference. It also denies that the sums received by it constitute property belonging to the Plaintiff Trustee.

The evidence of Robert R. Duval, Manager of the Melrose and Highland Branch of Defendant, a witness called on behalf of the Trustee in Bankruptcy under Section 21(j) of the Bankruptcy Act, shows the following:

Defendant loaned to Alvera Gordon Jones $2,000.00 on January 6, 1947, on a promissory note due in ninety days. On April 30, 1947, this note was renewed for an additional ninety days [R. 35]. On July 30, 1947, this note was again renewed for sixty days [R. 36]. On October 22, 1947, there was a payment made on this note of $250.00; a second payment of $100.00 on October 31, 1947; a third payment of $150.00 on December 2, 1947; so that on December 3, 1947, there was a balance due on this note of $1,500.00, and the note was then renewed for ninety days. On December 18, 1947, $50.00 was paid

thereon, and on January 23, 1948, the note was paid in full [R. 37].

Mrs. Jones had been a good customer of the Defendant for some time. The Defendant had financial statements in its records, the latest one of which was obtained March 31, 1947 [R. 38]; and it received no financial statements after March 31, 1947 [R. 39]. During the summer of 1947 some time Mrs. Jones asked for additional funds, and presented to Defendant a statement which she took back with her after Defendant looked at it. This statement showed that she had a net worth [R. 39].

On July 30, 1947, Defendant had a conversation with Mrs. Jones with reference to the payment of the note; and she requested additional time in which to pay it off, stating that she had taxes that she wanted to meet at that time [R. 40]. Between September 30 and December 6, 1947, Defendant had conversations with Mrs. Jones, and during one of these conversations she requested more money and submitted certain figures to the Defendant [R. 41]. She was told that Defendant should first be paid off before it considered additional loans, and at the same time she was given the names of outside loan companies who would probably be interested in her deal [R. 42]. In October, November, and the early part of December, 1947, she was advised to sell some of her beauty shops by Defendant in order to get in a better position [R. 43]. During the entire period of the loan involved Mrs. Jones was overdrawn many times, and Defendant honored the overdrafts [R. 44]. These overdrafts arose as follows: Mrs. Jones had approximately sixteen shops, in which she generally carried individual bank accounts wherever it might be convenient to the beauty shop, and about once a

week her manager would send in duplicate deposit tickets showing how much she had deposited in these various bank accounts, and upon those deposit tickets she would draw a check, which she would deposit in her main account, where the overdrafts arose. Thus Defendant would be willing to go ahead and grant temporary overdrafts, as it knew the money was coming through [R. 87]. A few times checks were returned for insufficient funds [R. 44].

In the summer of 1947 Defendant knew that Mrs. Jones was probably losing money on a couple of her shops [R. 49], and it understood she had about sixteen. It was told that she was making money on the rest of them [R. 49]. In August, 1947, when Mrs. Jones submitted figures, Defendant was shown a regular audit, and this audit showed a net worth at that time [R. 49-50]. The only financial difficulties Mrs. Jones ever discussed with Defendant would be temporary ones, in which she needed temporary working capital for a temporary period; and no conversation was ever had with her relative to whether her business was in an financially sound condition or otherwise [R. 87]. Plaintiff's Exhibit 2 [R. 15-24] was shown Mr. Duval, and he identified it as the financial statement or balance sheet that was presented to him by Mrs. Jones [R. 88]. This was the last financial statement or balance sheet Defendant ever saw [R. 89], and showed a net worth of $19,450.35 [Testimony of Austin H. Ellis, R. 56].

The policy of Defendant was that, although it might have an understanding with a customer that it might extend him credit for a year's time, still a note would ordinarily be written for from sixty to ninety days, with the

understanding that it would take a look at it at that time and, if it felt satisfied with the customer's position, would grant him an additional period of time on the note. There was nothing unusual about renewing the note for Mrs. Jones, and that happened any number of times within the bank, the granting of renewals when it felt justified [R. 89-90]; and one of the main reasons for granting the renewals of the note to Mrs. Jones was that Mrs. Jones was going to dispose of some of her stores, and Defendant felt that by disposing of those she would have sufficient working capital and sufficient funds to pay off the bank when she found suitable buyers [R. 91].

Mr. Austin H. Ellis, the public accountant who testified on behalf of the Trustee in Bankruptcy, testified that the statement prepared by him in August, 1947 [R. 52], and introduced as Plaintiff's Exhibit 2, showed a net worth of $19,450.35, as heretofore stated. This statement was dated August 31, 1947 [R. 59]. He was questioned on direct examination as to various figures in this statement [R. 50-59].

The testimony of Alvera Gordon Jones, a witness called on behalf of the Trustee in Bankruptcy under Section 21(j) of the Bankruptcy Act, shows:

That she did business under the name of Leroy Gordon Beauty Salons; that in 1948 she sold a store in San Bernardino [R. 60]; and that with at least $1,400.00 of the proceeds she paid the note she then owed to the Defendant [R. 61-62].

She testified as to the renewals of the note [R. 64-65], and that she showed Plaintiff's Exhibit 2 to Mr. Duval and requested a loan [R. 66]. She stated that in December,

1947, she had a conversation with Mr. Duval in which he stated he would have to have a renewal on the note, and on a demand basis not to exceed ninety days; that she had a discussion with Mr. Duval at that time, and he knew she was having financial difficulties because she had not been able to pay the $2,000.00 on a monthly basis [R. 68-69]; that Mr. Duval knew she was losing money right along [R. 70]; that she had conversations with Mr. Duval which she didn't remember; that she was in and out of the bank every day; that she didn't always stop to talk with Mr. Duval, but he always asked her how the business was going, and she always said, "We are doing fine; we are getting along grand"; that she may have said that some of the stores were not making money [R. 72]. That Mr. Duval spoke about the note, that it had been renewed several times and he was concerned about it; that she told him if she could sell the store, and when she did sell it she would take care of the loan, and that the understanding was that she would do so as quickly as she could [R. 73]. That she didn't believe she told Mr. Duval at the time of the renewal of the note that she would sell the store or any one of them for that purpose; it was understood that she would sell those stores, not just to dispose of them, but to sell them wisely, to be able to take care of not only the obligation with the Security, but with the creditors, and she believed the creditors understood that, too. She had conversations with reference to selling the stores over a period of time while she was attempting to work out a betterment of the situation of disposing of the stores that were not paying, and having that amount of capital to use for other purposes. This was during the latter part of 1947 [R. 74].

She was asked the question as to whether or not, at the time she was turned down for an additional loan, she told Mr. Duval that conditions were becoming so serious that it might be necessary for her to go into receivership [R. 75]. Former testimony given before the Referee in Bankruptcy was read to her, which she denied, and further stated that she did not believe she had ever said anything about receivership to Mr. Duval [R. 76]. She then stated that she was not well, and that she wanted to make some arrangement for her business so that she could have some time for herself for two or three months, but that it was not with the thought of going into bankruptcy or complete failure; and, if she ever had had a conversation with Mr. Duval, it was in that trend, and not the fact that she had completely failed and the business was gone [R. 76-77]. When asked the question as to whether or not she knew that her business was in severe financial difficulties, and that she was looking for some plan to try to work it out so that the bank and all of her creditors would have been paid in full, her answer was yes, that she told Mr. Duval she would like capital, and that she wanted capital to better her situation [R. 77]. Mrs. Jones did not file a voluntary petition in bankruptcy [R. 79].

On cross-examination Mrs. Jones was asked whether or not she had any conversation with Mr. Duval which would indicate to him that she was contemplating going into bankruptcy, or that she was insolvent, to which she replied, "No" [R. 82]. She was asked if Mr. Duval ever asked her if she were insolvent, or how she was getting along in her business, to which she replied that that question, "How are you getting on in your business?" is an every-day question; that she never went into lengths as to

what the problems were many times, she said that business was slow, or business was up; that she didn't believe she ever indicated to Mr. Duval that her business was insolvent [R. 82-83]. That when she went to the bank for the additional loan and presented the statement of August 31, 1947, to Mr. Duval, she wanted $12,000.00, but that Mr. Duval told her the amount was more than he could lend from the Branch, and he would have to refer her to the Head Office, and that the Head Office told her that they did not make loans on beauty salons as such, and that that was the reason they referred her to a finance company; and that the loan was not turned down because of financial difficulties; that she had been overdrawn at the bank many times prior to October, 1947 [R. 84-85].

The three witnesses, Robert R. Duval, Austin H. Ellis, and Alvera Gordon Jones, were all of the witnesses who testified on the trial of the cause.

Jurisdiction.

Jurisdiction of this appeal is conferred by Section 225(c) of Title 28, U. S. C. A., which includes "controversies, and cases had or brought in the district courts under Title 11, relating to bankruptcy, . . ." This jurisdiction is also conferred by Section 47a of Title 11, U. S. C. A. See also *Childs v. Ultramares Corp.* (Second Circuit), 40 F. 2d 474, at 477, where it is said:

> " 'Controversies' are ordinary suits in equity or actions at law between the Trustee as such and adverse claimants of property; . . ."

Appellant's Specifications of Error.

(1) As a matter of law, the District Court erred in holding that Plaintiff had sustained his burden of proof which was upon him to prove every element of a preference under the Bankruptcy Act, in that the proof of Plaintiff fails to show that the Defendant had reasonable cause to believe that the bankrupt was insolvent at the time of said transfers.

(2) The District Court erred in finding that Defendant was in possession of such facts concerning the bankrupt's business as would give it reasonable cause to believe that the bankrupt was insolvent.

Statement of Questions Involved.

The two legal questions urged by Appellant here are:

(1) Did Plaintiff sustain the burden of proof which was upon him to prove every element of a preference under the Bankruptcy Act?

(2) Did the evidence sustain the Finding [Finding IX, R. 9] that Appellant was in possession of sufficient facts concerning the bankrupt's business as would give it reasonable cause to believe that the bankrupt was insolvent?

ARGUMENT.

POINT I.

Did Plaintiff Sustain the Burden of Proof Which Was Upon Him to Prove Every Element of a Preference Under the Bankruptcy Act?

One of the elements of a preference under Section 60a of the Bankruptcy Act is the making or suffering of a transfer of property by a debtor while insolvent. Subdivision b of Section 60 of the Bankruptcy Act provides that upon a proof of a preference it may be avoided by the Trustee upon showing that the creditor receiving or to be benefited by the preference had reasonable cause to believe that the debtor was insolvent. No avoidance of a preference can be had unless the transferee did have such reaable cause to believe that the debtor was insolvent at the time of such transfer. The burden of proving the existence of all essential elements is upon the Trustee seeking to avoid the transfer. (*Anderson v. Stayton State Bank,* 82 Ore. 357; 38 American Bankruptcy Reports, 4; 159 Pacific, 1003.) The mere inability to meet current obligations is not insolvency in the bankruptcy sense, which is the excess of liabilities over assets at a fair valuation. (*Matter of Aughenbaugh,* 33 Fed. Supp. 671; *Cusick v. Second National Bank,* 115 Fed. Rep. Second Series, 150.)

It is respectfully urged by Appellant that Appellee did not sustain his burden of proof requiring him to establish that Appellant had reasonable grounds to believe that the bankrupt was insolvent at the time of the transfers.

The evidence of Mr. Duval shows that on January 6, 1947, Appellant loaned the bankrupt $2,000.00 on an unsecured promissory note; that this note was renewed from

time to time until January 23, 1948, when it was paid in full; that the last financial statement obtained by Appellant was on March 31, 1947; that Appellant saw the statement prepared by the public accountant dated on or about August 31, 1947, and that that statement showed a net worth of $19,450.35. There is no evidence that Appellant ever saw any statement or figures relative to the bankrupt's business after the statement aforesaid.

One of the main points of Appellee was that, because Appellant allowed the bankrupt overdrafts, this sustained the legal proposition that Appellant had reasonable grounds to believe the bankrupt was insolvent. But the evidence shows that the bankrupt operated approximately sixteen beauty salons, and that the money would be collected from these salons and then deposited in the bankrupt's account, and that Appellant understood the method of operation of the bankrupt and permitted these overdrafts as a customary thing, for the reasons stated. These overdrafts had been permitted in the early part of 1947 as well as in the latter part of the year.

The evidence also shows that it was customary for Appellant to renew customer's notes from time to time if it felt warranted. Could it be reasonably said that, if Appellant felt that the bankrupt would be unable to pay its note and would be unable to make good the overdrafts, Appellant would have permitted these things to go on? It is respectfully urged that the only reason Appellant did permit overdrafts and did renew the note was its belief in the solvency of the bankrupt. This would seem to be

the only logical explanation of Appellant's procedure in this matter.

Nowhere is the evidence of Mr. Duval contradicted; nor was the Appellee able to establish any knowledge on the part of Appellant that the bankrupt was in any financial difficulties other than that she was short of working capital, and that a few of her beauty salons were not making money and she was advised to sell them. Although Appellee endeavored to do so, he was unable to prove by Mr. Duval that Appellant ever told the bankrupt that she should go into receivership, or that the bankrupt ever told Mr. Duval that she thought she should go into receivership. The most that could be said is that the bankrupt never had enough working capital, but it is contended by Appellant that a shortage ow working capital is certainly no proof of insolvency, nor is it a thing that would give anyone reasonable cause to believe that the bankrupt was insolvent within the meaning of the Bankrupty law. Certainly, even if a person had reasonable cause to suspect that another was insolvent, or would be apprised of circumstances that would merely excite suspicion that someone was insolvent, this would be insufficient to prove a reasonable cause to believe. See *McDougal v. Central Union Conference Association of Seventh Day Adventists,* 110 Fed. Rep., Second Series, 939, wherein it is said in part as follows:

> "Temporary failure of a debtor to discharge his obligations promptly when they fall due is not in

itself sufficient to prove that a creditor who is aware of such default has reasonable cause to believe that it was not intended to give a preference by means of a transfer which he obtains. . . . 'Reasonable cause to suspect' does not have the same meaning as 'reasonable cause to believe', and reasonable cause to believe that a transaction would constitute a preference is not proven by circumstances that would merely excite suspicion."

It is the position of Appellant that the last information it had of the financial condition of the bankrupt was that she had a net worth of over $19,000.00, that she was somewhat short of working capital, and that she was going to sell a few of her shops to improve her liquid position from the standpoint of working capital; that the granting of overdrafts to the bankrupt was an habitual and customary thing, by reason of the number of her shops and the collection of her money into a central account, and that there was nothing unusual in renewing her loan; that the logical interpretation of the evidence is that, if Appellant had any cause at all to believe that the bankrupt was insolvent, it would not have continued to renew her loans, nor would it have permitted her overdrafts from time to time; and that the Trustee in Bankruptcy has utterly failed to sustain the burden of proof which is upon him to prove that Appellant had any reasonable cause or any cause at all to believe that the bankrupt was insolvent at the time of the transfers.

POINT II.

Did the Evidence Sustain the Finding [Finding IX, R. 9] That Appellant Was in Possession of Sufficient Facts Concerning the Bankrupt's Business as Would Give It Reasonable Cause to Believe That the Bankrupt Was Insolvent?

As the evidence has been heretofore set out and discussed by Appellant, it will not take the time of the Court to reiterate it under this point; and, if Appellant believed that there was any substantial evidence at all to sustain Finding IX, it would not urge this point on this appeal, it being aware that, if there is substantial evidence to support a finding, the finding will not be disturbed by the appellate tribunal. But it is the position of Appellant here that there is no evidence of any substantial character whatever to support this Finding.

In the case of *Brookheim v. Greenbaum,* 225 Fed. Rep. 635, affirmed in 225 Fed. Rep. 763, it was held that, if the bankrupt was concededly unbusinesslike and slovenly in his business transactions, a failure to maintain his credit by prompt payments, and a shortness of cash and absence of free capital, continuing for a long period without insolvency, are not of themselves sufficient to put on inquiry all who deal with him.

In *Cusick v. Second National Bank,* 115 Fed. Rep., Second Series, 150, the Court declared:

> "The nature of reasonable cause to believe a debtor insolvent was authoritatively defined by the Supreme Court in *Grant v. First National Bank* (97 U. S. 80, 24 L. Ed. 971) as follows:
>
> " 'Some confusion exists in the cases as to the meaning of the phrase, "having reasonable cause to be-

lieve such a person is insolvent." *Dicta* are not wanting which assume that it has the same meaning as if it had read, "having reasonable cause to suspect such a person is insolvent." But the two phrases are distinct in meaning and effect. It is not enough that a creditor had some cause to suspect the insolvency of his debtor; but he must have such a knowledge of facts as to induce a reasonable belief of his debtor's insolvency, in order to invalidate a security taken for his debt. To make mere suspicion a ground of nullity in such a case would render the business transactions of the community altogether too insecure. It was never the intention of the framers of the act to establish any such rule. *A man may have many grounds of suspicion that his debtor is in failing circumstances, and yet have no cause for a well-grounded belief of the fact. He may be unwilling to trust him further; he may feel anxious about his claim, and have a strong desire to secure it,—and yet such belief as the act requires may be wanting.* Obtaining additional security, or receiving payment of a debt, under such circumstances is not prohibited by the law. Receiving payment is put in the same category, in the section referred to, as receiving security. Hundreds of men constantly continue to make payments up to the very eve of their failure, which it would be very unjust and disastrous to set aside. And yet this could be done in a large proportion of cases if mere grounds of suspicion of their solvency were sufficient for the purpose.

" 'The debtor is often buoyed up by the hope of being able to get through with his difficulties long after his case is in fact desperate; and his creditors, if they know any thing of his embarrassments, either participate in the same feeling, or at least are willing to think that there is a possibility of his succeeding.

To overhaul and set aside all his transactions with his creditors, made under such circumstances, because there may exist some grounds of suspicion of his inability to carry himself through, would make the bankrupt law an engine of oppression and injustice. It would, in fact, have the effect of producing bankruptcy in many cases where it might otherwise be avoided.

" 'Hence the act, very wisely, as we think, instead of making a payment or a security void for a mere suspicion of the debtor's insolvency, requires, for that purpose, that his creditor should have some reasonable cause to believe him insolvent. He must have a knowledge of some fact or facts calculated to produce such a belief in the mind of an ordinarily intelligent man.' (Italics supplied.)"

In the case of *Everett v. The Warfield Mining Co.,* 37 Fed. Rep., Second Series, 328, it is held that a creditor may feel anxious about his claim and have a strong desire to secure it or have it paid, and yet not have such belief as the Act requires.

In the case of *Matter of Florsheim,* 24 Fed. Supp. 991, it was held that financial statements given by a bankrupt to a bank are pertinent evidence as to whether the bank had reasonable cause for belief.

In the case of *Matter of Williams,* 35 American Bankruptcy Reports, New Series, 100, it was held that a bank's knowledge that debtor's checks had been returned for insufficient funds was insufficient to show reasonable cause to believe the debtor was insolvent.

The financial statement dated on or about August 31, 1947, shown to Appellant by the bankrupt, far from indicating insolvency, indicated the exact opposite. This state-

ment was prepared by a public accountant, not by the bankrupt; it was introduced into evidence by the Trustee in Bankruptcy himself. The overdrafts were a customary thing, and the reasons for them were given. There is no positive proof on the part of the Trustee in Bankruptcy that the bankrupt ever indicated to Appellant that she was in any worse financial situation than being short of working capital. There does not seem to be any conflict in the testimony; and it is the position of Appellant that there is no substantial evidence whatsoever to sustain the Finding aforesaid. It is contended that there is not even sufficient proof of any facts that would even cause anyone to suspect the insolvency of the bankrupt at the time of the transfers.

Conclusion.

It is respectfully submitted that the burden of proof was upon Appellee; that he failed to sustain such proof; and that the record discloses no substantial evidence upon which Finding IX could be justified; and that the judgment should be reversed.

Respectfully submitted,

ROANE THORPE,
Attorney for Appellant.